CONTENTS

CHAPTER ONE: SCOPE AND OUTLINE OF THE BOOK 1

1.1. Principal aim of the book 1
1.2. Theory of corporate finance 1
1.3. Dynamics of the firm 3
1.4. Relevance and motivation of the book 3
1.5. Subproblems 4
1.6. Outline of the book 5

CHAPTER TWO: MODELS OF DYNAMIC BEHAVIOUR 9

2.1. Introduction 9
2.2. Dynamic and management modelling 11
2.2.1. Exponential growth 11
2.2.2. Multiperiod constraints 14
2.2.3. Dynamic control 15
2.3. A dynamic theory of the firm: investment, finance and dividend 20
2.3.1. The firm's objective 20
2.3.2. Input and its transformation to output 22
2.3.3. Finance and government 25
2.3.4. Additional assumptions 29
2.3.5. Summary of the basic model and general solution procedure 29
2.3.6. Optimal policy strings 31
2.3.7. Summary and conclusions 37
2.4. Dynamic modeling: survey and conclusions 38

CHAPTER THREE: TAXATION AND SOME IMPLICATIONS 41

3.1. Introduction 41
3.2. Some examples 42
3.3. Fiscal (non) neutrality 44
3.4. Different types of profit and income tax regimes 45
3.4.1. Classical system 46
3.4.2. Two rate system 47
3.4.3. Imputation system 48
3.4.4. Integrated system 48
3.4.5. Neutrality of the tax regimes 49
3.5. Leverage and the value of a firm 49
3.5.1. Irrelevancy theorem of Modigliani and Miller 51
3.5.2. Corporate tax correction theorem 52
3.5.3. Leverage related costs 54
3.5.4. Personal taxes 56
3.6. Leverage and market equilibrium 58
3.6.1. Before Tax Theory 59
3.6.2. After Tax Theory 60
3.7. Conclusion 62

CHAPTER FOUR: FINANCIAL MARKET EQUILIBRIUM UNDER TAXATION AND TAX INDUCED CLIENTELES EFFECTS 65

4.1. Introduction 65
4.2. Dividend and leverage irrelevancy theorem under personal taxation 66
4.3. Dividend and financial leverage clienteles 71
4.4. Equilibrium market value reconsidered by Gordon 75
4.5. Discussion and extension of Gordon's framework 78
4.5.1. Investor's objective and the Modigliani-Miller framework 79
4.5.2. Supply adjustment of debt by firms 81
4.5.3. Value of a firm with interior leverage rate 82
4.5.4. Miller versus Gordon 84

4.6. A corrected equilibrium approach 85
4.7. Tax induced investment clienteles 87
4.8. Conclusion 91

CHAPTER FIVE: OPTIMAL POLICY STRING OF A SINGLE VALUE MAXIMIZING FIRM UNDER PERSONAL TAXATION 93

5.1. Introduction 93
5.2. The model 94
5.3. Optimal solution 97
5.4. Further analysis 101
5.5. Sensitivity analysis 105
5.5.1. Influence of the fiscal parameters 106
5.5.2. Influence of the financial parameters 109
5.5.3. Interaction of fiscal parameters and the time preference rate 110
5.5.4. Switch of tax regime 112
5.5.5. Initial value and planning horizon 113
5.6. Conclusion 114

CHAPTER SIX: INDIVIDUAL INVESTOR BEHAVIOUR UNDER EQUILIBRIUM CONDITIONS 117

6.1. Introduction 117
6.2. Free end point approach under equilibrium conditions 118
6.3. A competitive approach 128
6.4. A differential game approach 134
6.4.1. Theory on differential games 134
6.4.2. Modeling the problem under consideration 136
6.4.3. A Pareto solution of the problem 137
6.5. Conclusion 142

CHAPTER SEVEN: A TIME DEPENDENT EQUILIBRIUM APPROACH UNDER A PROGRESSIVE PERSONAL TAX 143

7.1. Introduction 143
7.2. Optimal behaviour of an equity financed firm 144
7.3. Valuation of the firm's policy string 149
7.4. Market equilibrium approach 154
7.5. Final results and conclusion 158

CHAPTER EIGHT: CONCLUSIONS 161

APPENDIX A1: THE SOLUTION OF THE OPTIMAL CONTROL PROBLEMS FORMULATED IN THE CHAPTERS TWO AND FIVE 165

APPENDIX A2: DERIVATION OF A PARTICULAR EXPRESSION IN CHAPTER FIVE 183

APPENDIX B1: DERIVATION OF OPTIMAL SWITCHING POINT 185

APPENDIX B2: SOLUTION OF OPTIMAL CONTROL PROBLEM FORMULATED IN CHAPTER SIX 187

APPENDIX B3: A PARETO SOLUTION OF A DIFFERENTIAL GAME 197

APPENDIX C: DERIVATION OF A PARTICULAR EXPRESSION IN CHAPTER SEVEN 204

LIST OF SYMBOLS 207

REFERENCES 209